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No. 97-1679

In the Supreme Court of the United States

OCTOBER TERM, 1997

UNUM CORPORATION AND UNUM LIFE INSURANCE COMPANY OF AMERICA, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the transfer of stock and cash to policyholders of a mutual insurance company to extinguish their membership interests in that company constitutes a deductible "policyholder dividend" under Section 808 of the Internal Revenue Code, 26 U.S.C. 808.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 61a) is reported at 130 F.3d 501. The opinion of the district court (Pet. App. 38a-60a) is reported at 929 F. Supp. 15.

JURISDICTION

The judgment of the court of appeals was entered on December 2, 1997. On February 5, 1998, Justice Souter extended the time for filing a petition for a writ of certiorari to April 16, 1998 (Pet. App. 62a). The petition for a writ of certiorari was filed on April 14, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. Petitioner UNUM Life Insurance Company is the successor to Union Mutual Life Insurance Company. Prior to 1986, Union Mutual was a mutual insurance company incorporated under the laws of the State of Maine (Pet. App. 5a). As a mutual insurance company, Union Mutual was owned by its policyholders, who held voting rights in the company, were entitled to share in its surplus upon liquidation and possessed preemptive rights in the event the company converted to a stock company (*id.* at 5a & n.1).

In 1984, Union Mutual decided to "demutualize," which is the term employed to describe the conversion from a mutual insurance company to a stock insurance company (Pet. App. 5a-6a). The primary reason for doing so was to provide access for the company to capital sources other than its policyholders. The company submitted a proposed plan of conversion for approval by the Maine Superintendent of Insurance.[1] The Superintendent approved an

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[1] The applicable Maine statute specifies various conditions that the plan of conversion must satisfy to receive approval by the Superintendent. The statute requires, *inter alia*, (i) that the terms of the plan be fair and equitable, (ii) that the "equity share" of each "member" of the insurer (as defined in (v) below) be determinable by the Superintendent under a fair and reasonable formula based upon the insurer's entire surplus as shown by its financial statements, (iii) that the plan give each member of the insurer a preemptive right to acquire his proportionate part of the proposed capital stock of the stock company, (iv) that the plan provide for payment to each member of his entire equity share in the insurer, with the payment to be made in cash or stock of the stock company, and (v) that the "members" entitled to receive stock or cash include all policyholders within three years prior to the date

amended plan for the demutualization of Union Mutual on August 8, 1986 (*id.* at 6a).

The final plan of conversion provided for the creation of a holding company to own the stock of the new stock insurance company (Pet. App. 7a). Under the plan, the policyholders of the mutual insurance company were to transfer their "membership interests"[2] in the mutual insurance company to the holding company. In return, they were to receive stock of the holding company or, if they qualified as "cash option eligible policyholders," they could choose instead to receive cash from the mutual company (*ibid.*).[3] The holding company was then to exchange the membership interests it thus acquired in the mutual company for the shares of the new stock company (*ibid.*). To raise additional capital, the holding company was thereafter to issue and sell additional stock to the general public (*ibid.*).

The plan of conversion provided an actuarial formula for determining the consideration to be provided

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the plan was submitted for approval to the Superintendent. See Pet. App. 6a.

[2] The plan of conversion generally defined the term "membership interest" as (Pet. App. 7a):

> all the rights or interests of each policy and contract holder of Union Mutual including, but not limited to, any right to vote, any rights which may exist with regard to the surplus of Union Mutual not apportioned by the Board for policyholder dividends, and any rights in liquidation or reorganization of Union Mutual * * *.

[3] Cash option policyholders were policyholders whose equity share was less than $2,500 (Pet. App. 7a n.3). Policyholders who received stock from the holding company were also to receive cash from the mutual company in lieu of fractional shares of stock.

to policyholders in exchange for their membership interests in Union Mutual (Pet. App. 8a). This figure, which was denominated the policyholder's "equity share," was defined as "the dollar amount of that part of Union Mutual's Adjusted Surplus attributable to" the particular policyholder (*ibid.*).[4] "Adjusted surplus" was the amount of surplus shown on the company's financial statement as of December 31, 1985, which was $652,050,097 (*ibid.*).

c. Before implementing the plan of conversion, Union Mutual requested a private letter ruling from the Internal Revenue Service concerning certain tax consequences of the conversion (Pet. App. 10a-11a). In particular, Union Mutual sought a ruling that the transfer by policyholders of membership interests in the mutual company for stock of the holding company would be treated as a tax-free "exchange" within the meaning of 26 U.S.C. 351(a) (Pet. App. 11a).[5] Union Mutual further requested a ruling that the proposed exchange of the equity interests received by the holding company for the common stock of the new

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[4] The "equity share" reflected two components: (i) the relative contribution to statutory surplus made by eligible policyholders and (ii) the value of the intangible membership rights in the mutual company surrendered by the policyholders (Pet. App. 8a). These intangible rights were valued at $612.25 per equity share (*ibid.*).

[5] Section 351(a) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation." 26 U.S.C. 351(a). Union Mutual requested the Section 351 ruling out of concern that its policyholders would otherwise be required to recognize gain (and therefore be subject to tax) on the exchange of equity interests.

stock company would be treated as a tax-free recapitalization under 26 U.S.C. 368(a)(1)(E) (Pet. App. 11a).

The Service responded with a private letter ruling addressing the tax consequences of the conversion. The ruling stated (i) that the transfer of membership interests in Union Mutual by eligible policyholders in exchange for stock of the holding company constituted an exchange within the meaning of 26 U.S.C. 351(a) and thus was not taxable to the policyholders and (ii) that the exchange of the membership interests in Union Mutual received by the holding company for the voting common stock of the new stock company constituted a tax-free recapitalization within the meaning of 26 U.S.C. 368(a)(1)(E) (Pet. App. 11a-12a). The ruling described the cash transferred to policyholders in exchange for their membership interests in Union Mutual as a nondeductible redemption of stock under 26 U.S.C. 302 (Pet. App. 12a).

d. In November 1996, Union Mutual implemented its plan of conversion to a stock company named UNUM Life Insurance Company (Pet. App. 10a). As part of that conversion, the newly-created holding company issued 20,489,072 shares of its stock to eligible policyholders in exchange for their membership interests in the mutual company (*ibid.*). The fair market value of the holding company's stock on the date of issuance was $25.20 per share. The total value of the shares received by policyholders was therefore $522,471,336 (*ibid.*). In addition, as part of the same conversion transaction, Union Mutual transferred cash in the amount of $129,129,082 to the eligible policyholders who elected cash redemption of their mutual shares (*ibid.*).

2. Petitioners filed a consolidated federal income tax return for 1986. On that return, petitioners did not claim a deduction for the value of the cash and stock that was transferred to policyholders as part of the conversion (Pet. App. 12a-13a). In 1992, however, petitioners filed an amended return in which they asserted that the cash transferred to policyholders ($129,738,478) constituted deductible "policyholder dividends" under 26 U.S.C. 805(a)(3) and 808 (Pet. App. 45a). Petitioners thereafter filed a second amended return in which they asserted that the fair market value of the stock transferred by the holding company to the former mutual shareholders ($522,471,336) was also a deductible "policyholder dividend" under those provisions (*ibid.*). When the Internal Revenue Service did not grant the refunds requested on the amended returns, petitioners filed this refund suit in district court (*ibid.*).

3. The district court held that petitioners were not entitled to the claimed deduction (Pet. App. 59a-60a).[6] The court concluded that the transfer of stock and cash to Union Mutual policyholders in exchange for their membership interests in the company constituted a redemption of stock and did not constitute a "policyholder dividend" under Section 808(a) of the Code (*ibid.*). The court noted that the statute defines the term "policyholder dividend" generally to mean

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[6] Prior to ruling for the United States on the merits, the district court denied a motion for summary judgment filed by the government contending that principles of judicial estoppel and the duty of consistency precluded petitioners from claiming a policyholder dividends deduction with respect to the conversion. The petition (Pet. 9) erroneously implies that the district court's denial of the motion related to the merits of the case.

"any dividend or similar distribution to policyholders in their capacity as such" (26 U.S.C. 808(a)). The court explained that an amount received in exchange for a shareholder's proportional interest in a company, and in exchange for property of equivalent value, constitutes a redemption or exchange and not a "dividend" (Pet. App. 48a-53a). The court emphasized that petitioners had failed to produce any authority that defines the term "dividend" to include a transfer to a shareholder made in exchange for property of equivalent value (*id.* at 52a).

4. The court of appeals affirmed in a lengthy and detailed opinion (Pet. App. 1a-37a). The court noted that general corporate tax law applies to insurance companies in the absence of some specific provision to the contrary in the insurance tax section of the Internal Revenue Code (Subchapter L). Under general corporate tax principles, corporations are not allowed deductions for exchanges occurring with either shareholders or third-parties during the course of a corporate restructuring (Pet. App. 20a). The court concluded that this well-established general tax principle applies to the transaction involved here because nothing in Sections 805 and 808 of the Code clearly authorize a deduction for stock and cash transferred to policyholders in exchange for their membership interests in the course of a demutualization (*id.* at 14a, 25a-31a). The court held that petitioners had failed to establish "that the term 'policyholder dividend' under § 808(a) includes value-for-value exchanges that occur during a corporate reorganization such as this" (*id.* at 20a).

ARGUMENT

The court of appeals correctly concluded that petitioners are not entitled to a federal income tax deduction for the $652 million in stock and cash that they transferred in exchange for, and in redemption of, the rights of the policyholders in the mutual insurance company. The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Indeed, this case presents an issue of first impression. Further review is therefore not warranted.

1. a. As the court of appeals correctly recognized (Pet. App. 20a-24a), general corporate tax principles plainly bar petitioners from claiming a deduction for the value of the stock and cash transferred to policyholders in exchange for and redemption of their rights in the mutual insurance company. Section 162(k) of the Internal Revenue Code states clearly that a deduction is not allowed "for any amount paid or incurred by a corporation in connection with the reacquisition of its stock" (26 U.S.C. 162(k)). See also 26 U.S.C. 311(a) ("no gain or loss shall be recognized to a corporation on the distribution [of property] with respect to its stock"); 26 U.S.C. 1032(a) ("[n]o gain nor loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock * * * of such corporation").

In addition to the specialized provisions (in Subchapter L of the Code) that address specific features of taxation for insurance companies, insurers are subject to the general corporate tax provisions of the Internal Revenue Code. For example, when, as in the present case, an insurance company seeks to engage in a tax-free reorganization under the general pro-

visions of Sections 351(a) and 368(a)(1)(E) of the Code, "the general [corporate tax] rules of the Internal Revenue Code, such as the rules relating to (i) the characterization of income, (ii) the recognition or nonrecognition of gain upon sales or exchanges, reorganizations, etc. and (iii) the taxation of shareholders" apply "[e]xcept to the extent that specific provision is made [for insurance companies in Subchapter L]." S. Rep. No. 291, 86th Cong., 1st Sess. 39 (1959). See *Colonial American Life Insurance Co.* v. *Commissioner*, 491 U.S. 244, 253, 260 (1989).

Petitioners do not dispute that the provisions of the Internal Revenue Code that apply generally to all "corporations" are expressly applicable to "insurance companies" as well (26 U.S.C. 7701(a)(3)).[7] Instead, they contend that a "specific provision" has been made for insurance companies in Sections 805(a)(3) and 808 of the Code that permits those companies a deduction—not permitted to any other type of corporation—for the value of stock and cash transferred to shareholders.

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[7] 26 U.S.C. 7701(a)(3) specifies that the term "corporation" for federal tax purposes "includes associations, joint-stock companies, and insurance companies." The statute further provides that "[t]he term 'stock' includes shares in an association, joint-stock company, or insurance company" (26 U.S.C. 7701(a)(7)) and that "[t]he term 'shareholder' includes a member in an association, joint-stock company, or insurance company" (26 U.S.C. 7701(a)(8)). This Court has long noted that the term "corporation" as used in the Internal Revenue Code "includes non-stock mutual insurance companies as well as those having capital stock" and that the term "shares" includes the membership interests of policyholders in a mutual insurance company. *Duffy* v. *Mutual Benefit Life Insurance Co.*, 272 U.S. 613, 616, 619-620 (1926).

b. Section 805(a)(3) of the Code allows a deduction for insurance companies for the amount of their "policyholder dividends" (26 U.S.C. 805(a)(3)). In Section 808(a) of the Code, the term "policyholder dividend" is defined to mean any "dividend or similar distribution to policyholders in their capacity as such" (26 U.S.C. 808(a)). As more particular examples, Section 808(b) further specifies that a "policyholder dividend" includes amounts paid or credited to policyholders "where the amount is not fixed in the [insurance] contract but depends on the experience of the company or the discretion of the management" and also includes items such as "premium adjustments" and "experience-related refunds" (26 U.S.C. 808(b)).

As the court of appeals correctly observed, the "policyholder dividend" provisions of Section 805 and 808 have "nothing to do with capital transactions altogether" (Pet. App. 25a). The express language of Section 808(a)(1), which defines a "policyholder dividend" as "any dividend or similar distribution to policyholders in their capacity as such," cannot be read to encompass the bilateral share exchange and redemption transactions involved in this case. The "term [dividend], as generally understood and used, refers to the recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business, which does not reduce their stock holdings and leaves them in a position to enjoy future returns upon the same stock." *Hellmich* v. *Hellman*, 276 U.S. 233, 237 (1928). See also *United States* v. *Davis*, 397 U.S. 301, 313 (1970) ("If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative

economic interests or rights of the stockholders."). The term, however, does *not* refer to a corporation's purchase of property from a shareholder for equivalent value. *Citizens Bank & Trust Co.* v. *United States*, 580 F.2d 442, 446 (Ct. Cl. 1978); *Commissioner* v. *Pope*, 239 F.2d 881 (1st Cir. 1957).

Because stock exchange and redemption transactions of the type engaged in by petitioners do not constitute a "dividend or similar distribution," they do not satisfy the standard for deductibility under Section 808(a). The court of appeals therefore properly rejected the extraordinary assertion advanced by petitioners that a mere corporate reorganization should yield an insurance company a $652 million income tax deduction (Pet. App. 25a).

2. Even though their claim is refuted by the plain text of Section 808(a), petitioners essentially ignore that provision. Petitioners instead contend (Pet. 13) that the stock exchange and redemption transactions involved in this case constitute a "policyholder dividend" because they are the culmination of petitioners' "experience" in the insurance business and therefore fit within the literal terms of Section 808(b)(1). See 26 U.S.C. 808(b)(1) (defining "policyholder dividend" to include qualified dividend payments based upon "the experience of the company"). That facile attempt to latch upon one word in a complex set of tax provisions was properly rejected by the court of appeals as an "attempt to sweep the language of § 808(a) under the table" (Pet. App. 19a).[8] As the court explained,

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[8] The court of appeals correctly rejected petitioners' contention (Pet. 26-28) that the legislative history and underlying purpose of Section 808 support their claimed deduction. As the court of appeals observed (Pet. App. 35a), "[n]othing UNUM

"[b]asic canons of statutory construction require it to consider the language of § 808(a) in construing § 808(b)" (*id.* at 25a, citing *United States National Bank of Oregon* v. *Independent Insurance Agents of America, Inc.*, 508 U.S. 439, 455 (1993)).[9] As the court stated in rejecting petitioners' implausible reading of the statute (*id.* at 33a):

> Had Congress wanted to provide insurance companies with a "policyholder dividend" deduction for any distribution to policyholders not fixed in the contract, it could simply have defined "policyholder dividend" as referring to "any distribution." It would not have limited the definition to "dividends or similar distributions" and then left it to the insurance industry to discover massive deductions in the shadows of the statute.

"[T]he plain meaning of § 808 works against, and not for, UNUM" (*ibid.*).

3. Petitioners err in contending that the question presented in this case "is one on which conflict and confusion exist" (Pet. 13). The cases cited by petitioners (Pet. 14) that advert to an "expansive"

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cites supports the proposition that Congress intended the term 'policyholder dividends' to encompass value-for-value exchanges occurring during a corporate reorganization."

[9] Petitioners err in contending (Pet. 19-26) that the decision in this case conflicts with settled norms of statutory construction. The court of appeals followed well-established principles of statutory construction by examining the statute as a whole and placing the provisions in their proper context. See *Conroy* v. *Aniskoff*, 507 U.S. 511, 515-516 (1993). By contrast, petitioners attempt to divorce Section 808(b)(1) from the other parts of the same statute and thus violate the settled rule that statutory phrases are not to be construed in isolation. See *United States* v. *Morton*, 467 U.S. 822, 828 (1984).

definition of "policyholder dividends" under provisions of the former Life Insurance Company Tax Act do not address value-for-value exchanges made in the context of a demutualization.[10] Instead, those cases concern unilateral actions of insurance companies to distribute surplus to shareholders in the ordinary course of business. As petitioners acknowledge indirectly (Pet. 11), the issue addressed by the court of appeals in the present case is one of first impression—in no prior case has an insurance company sought to obtain a deduction for its entire net worth in connection with a corporate reorganization.[11]

4. Petitioners mistakenly assert (Pet. 18) that the government has adopted "conflicting positions" in interpreting and applying the applicable provisions of the Code. As the court of appeals recognized (Pet.

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[10] Petitioners' reliance (Pet. 15) on former Treas. Reg. 1.811-2(a) (1961) is similarly flawed. That regulation did not address value-for-value exchanges between insurance companies and their policyholders; nor did it address transactions that alter the capital structure of an insurance company.

[11] Petitioners erroneously assert, albeit only in a footnote (Pet. 14 n.8), that the decision in this case is "at odds" with *Ruocco* v. *Bateman, Eichler, Hill, Richards, Inc.*, 903 F.2d 1232 (9th Cir.), cert. denied, 498 U.S. 899 (1990). That case concerned a provision of the California Insurance Code. The Ninth Circuit did not construe Section 808 in *Ruocco*. See 903 F.2d at 1236-1237. Its decision in that case therefore cannot be said to be in conflict with, or "at odds" with, any decision (such as the present case) involving that provision of the Internal Revenue Code. The possibility that stock transferred to policyholders in a demutualization could be characterized as a "dividend" for purposes of the California Insurance Code (or any other state law) is obviously irrelevant to this federal tax case. See *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932).

App. 11a-13a), the Service has consistently treated this transaction as a tax-free exchange that creates neither income for the shareholders nor a deduction for the insurer. By contrast, petitioners *have* taken conflicting positions in this case. As the court of appeals noted, petitioners originally "acknowledged that its demutualization was a capital transaction subject to general corporate tax law when it submitted its * * * request to the IRS for a private letter ruling regarding whether the conversion would be entitled to tax-free treatment" (*id.* at 21a n.8). It was only later, after obtaining a favorable ruling, that petitioners reversed ground to contend that the transactions represented dividends, which would give rise to a $652 million deduction for the company and an equivalent amount of income to its shareholders.

5. Petitioners err in relying (Pet. 23) on 26 U.S.C. 316. Section 316(a) generally defines a corporate dividend as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits" (26 U.S.C. 316(a)). Section 316(b) then further provides that "[t]he definition in subsection (a) shall not apply to the term 'dividend' as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such" (26 U.S.C. 316(b)). Section 316(b) was enacted because "policyholder dividends" (unlike corporate dividends) are not made solely from net income; instead, they include items such as premium adjustments and experience-related refunds that represent price rebates rather than distributions of net income. See 26 U.S.C. 808(b). As the court of appeals correctly recognized, the fact that a "policyholder dividend" is not necessarily distributed from net income does not mean that the term "encompasses any distri-

bution to policyholders regardless of its context or purpose" (Pet. App. 27a).[12] As the district court similarly stated in rejecting petitioners' reliance on Section 316(b) (Pet. App. 50a n.10):

> § 316(b)(1) *cannot* prohibit the application of other sources of law that help define "dividend" without thereby reading the term (and, consequently, "or similar") entirely out of the § 808(a) definition of "policyholder dividend." To read "dividend" as limitless in scope in the phrase "any dividend or similar distribution" is to read the phrase instead as "any distribution."

6. Contrary to petitioners' assertion (Pet. 21-22), the court of appeals properly relied on *Colonial American Life Insurance Co.* v. *Commissioner*, 491 U.S. 244 (1989), in reaching its decision in this case. The issue in *Colonial American* was whether ceding commissions paid by a reinsurance company to a direct insurer under a contract for indemnity reinsurance are fully deductible in the year tendered or must be amortized over the anticipated life of the reinsurance agreements. 491 U.S. at 246. The Court noted that there is a general tax principle that "amounts expended to acquire an asset with an income-producing life extending substantially beyond

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[12] Petitioners also err in relying on the general statement in *Republic National Life Insurance Co.* v. *United States*, 594 F.2d 530, 532 (5th Cir. 1979), that the term "policyholder dividends" in Section 808 includes more than classic corporate dividends. As the court of appeals correctly observed (Pet. App. 27a n.13) in this case, the statement of the Fifth Circuit in *Republic National* was not directed at value-for-value stock exchanges and redemptions occurring during a corporate reorganization.

the taxable year of acquisition must be capitalized and amortized over the useful life of the asset." *Id.* at 252-253. The Court held that that general tax principle controlled the outcome of the case "absent some specific statutory provision indicating that ceding commissions for indemnity insurance are an exception to the general rule for which Congress has authorized current deduction." *Id.* at 253. After concluding that there was no specific provision in Subchapter L that provided for the claimed deduction, the Court applied the general corporate tax rule to that case. *Id.* at 260.

The reasoning applied by this Court in *Colonial American* is directly applicable here. As the court of appeals concluded (Pet. App. 28a-31a), nothing in the provisions of Sections 805 and 808 that authorize a deduction for dividends and similar distributions by insurers also authorizes a deduction for capital transactions by insurers involving value-for-value exchanges and redemptions of corporate stock. The general corporate tax rule that denies a deduction for such exchanges (26 U.S.C. 162(k)) therefore controls in this case. Congress simply has not authorized the extraordinary tax bonanza for reorganizing insurers that petitioners seek.

7. Petitioners are not correct in asserting (Pet. 11-12) that certiorari should be granted in this case even in the absence of a conflict among the circuits. It is true, as petitioners point out (*ibid.*), that enormous tax consequences would ensue if petitioners' extraordinary contentions were adopted. But there is no precedent for petitioners' implicit suggestion that a taxpayer's bold misapplication of the Internal Revenue Code is somehow thereby made more worthy of review by this Court.

The cases cited by petitioners are plainly not on point. In cases such as *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989), and *United States* v. *Hill*, 506 U.S. 546 (1993), this Court reviewed decisions of the United States Court of Appeals for the Federal Circuit that were adverse to the government. Because that circuit has national jurisdiction over appeals in tax refund suits filed in the Court of Federal Claims—and every similarly situated taxpayer can therefore obtain review of tax claims in that circuit—the decisions of that circuit that are adverse to the government are nationally effective in the absence of review by this Court. It is for that reason that the United States sometimes requests review of decisions of the Federal Circuit in the absence of a conflict, and it is for that reason that this Court sometimes grants review of such cases.

That situation, however, obviously does not apply in this case. The decision of the court of appeals is not directly binding on any other taxpayer. It determines only the law applicable in the First Circuit. Moreover, even other insurance companies located in the First Circuit are not bound by this decision, for they can bring the issue to the Federal Circuit by commencing a refund action in the Court of Federal Claims. There is thus no conflict among the circuits or other reason to warrant review by this Court in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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